MMA Independent and Data Driven

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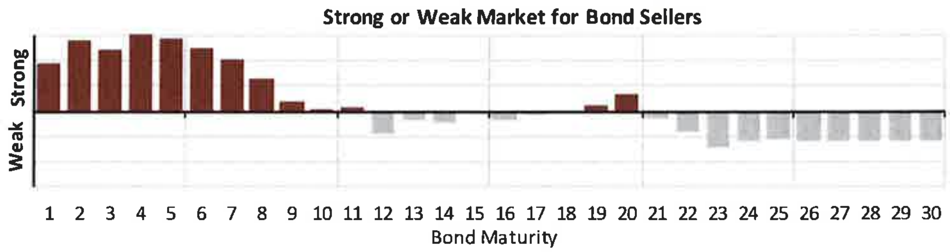
MUNICIPAL MARKET JOURNAL



MMA 5% AAA Benchmark

	2/5/2016	1/29/2016	Change
2-yr	0.57%	0.61%	-4
5-yr	1.01%	1.07%	-6
10-yr	1.76%	1.81%	-5
30-yr	2.76%	2.79%	-3

The front of the municipal curve became even stronger as separate managed accounts, individuals and banks pursued this range of the curve aggressively (positive maroon columns), in contrast the longer maturities have lagged even though mutual fund inflows have remained positive (negative gray columns).

MARKET UPDATE

Municipal 10-year yields have returned to their lowest levels since the first 6 months of 2013. However, the 5-year yield is 25 bps higher than three years ago, while the 30-year is 20 bps lower.

HIGHLIGHTS

- With a weaker than expected labor indicator and continued unease over US and global growth prospects generally, bond yields were lower again last week. Tax-exempts yields fell 3-7 bps, led by the front end for a slightly steeper curve.
- As expected, municipals continue to underperform the rally in US Treasury, relative-value ratios rising as the tax-exempt sector gets relatively cheaper versus taxables. Ratios at the 10yr and 30yr marks are at their highest points in a year, implying that municipals have now erased roughly a year's worth of outperformance.
- Still, the dearth of new issue supply (which, through the first five weeks of the year is now lagging 2015 by $7B) has been evident enough to keep the committed buyers buying. A jump in the forward calendar and sales this week will test current demand.
- Weekly fund inflows have averaged $1.3B since 12/24.
- And the cumulative effect of US Treasury rally and muni supply shortfall is clear: Last week, the average yield in **MMA's** AAA 5% curve (weighting all maturities equally) fell to its lowest level (2.17%) since January 2013. In other words, new purchases are providing less income for buyers than at any time except the historic lows in late 2012/early 2013. It is no wonder that, in this context, credit spreads are uncomfortably tight.
- **MMA**'s Municipal Value index also increased to a lower level, -45 bps, this quantifies the most favorable pricing environment for municipal bonds since January 2009. Compared to last September, municipal bond pricings include nearly a 30 bps pricing premium because of the strong investor demand and low issuance.
- And now that the spread between **MMA's** AAA 5% 30yr maturity and MMD's is back below 5bps, likely indicating buyer capitulation that, as in the May-July 2015 period, may be difficult to quickly shake off one way or the other.
- Finally another cloud in the silver lining of strong performance: permissive current underwriting conditions imply defaults and impairments of 2016 vintage could be elevated for risky credits.

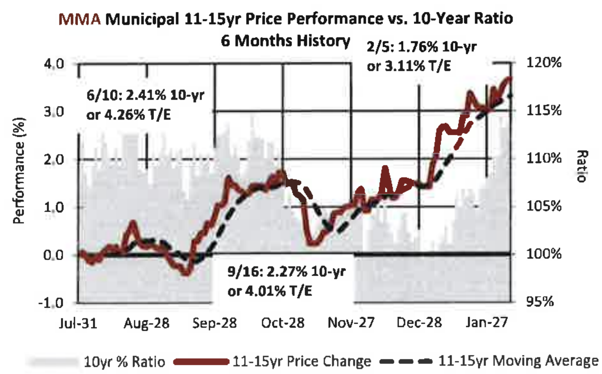


*Figure 1: **MMA** municipal price performance index has illustrated the consistent rally since November. Over the past year, investors were drawn to 4.00% taxable equivalent yields, now investors want safety.*

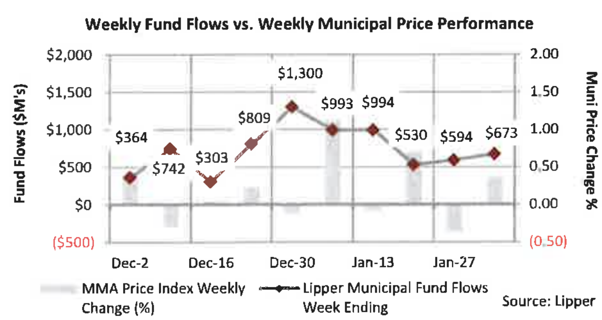


Figure 2: Municipal bond fund weekly flows remained positive.

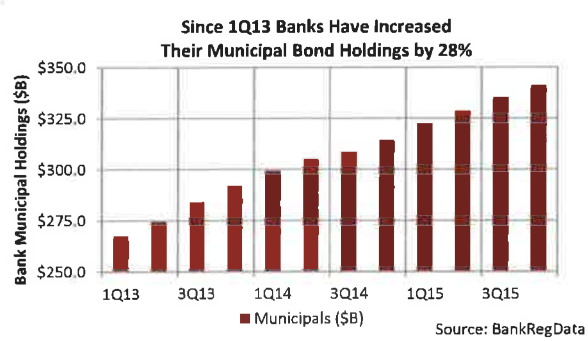


Figure 3: Banks have also increased their demand for municipal bonds and now Congress is apt to consider them more liquid assets, ***page 2.***

HQLA UPDATE

HQLA LEGISLATION LIKELY TO BECOME LAW: Legislation that would require Federal banking regulators to treat core municipal bond securities as high quality liquid assets (HQLA) under Basel III's liquidity coverage ratio (LCR) appears likely to become law in 2016. **MMA** expects minimal market impacts whether or not this actually happens: the large majority of banks buying municipals do so for safe income, not liquidity. On the other hand, final approval of this proposal would showcase the growing support for, and organization of, state and local government advocacy efforts in Congress. It remains likely, in our view, that that strength will be tested in 2017/18 when Federal tax reform efforts will once again begin to target public infrastructure subsidies and the tax exemption specifically.

On February 1, the full House of Representatives quickly passed legislation that would allow banks which are subject to LCR (generally those with at least $250B in assets) to treat investment grade and "liquid and readily marketable" municipal bonds as a level 2A asset: subject to a 15% haircut for the purposes of LCR, the same treatment as Federal agency securities. Ultimately the concern will be: can a bank convert this security to cash in times of market-wide stress? **MMA** assumes that each institution will answer this question differently, based on their own role and relative advantages in the municipal bond market, how they perceive and manage their own risk exposure, and how they derive the balance of their LCR assets. As **MMA** has detailed before, this may come down to whether a particular bank views municipals as structurally liquid (as are, for example, US corporate bonds which have programmatically robust CUSIP-by-CUSIP trading practices) or, effectively liquid (meaning that, despite single security liquidity deficiencies, the nature of the municipal market has rarely left investment grade tax-exempt bonds without a buyer for very long). Thus, while municipals-as-HQLA will certainly not hurt banks' investment in tax-exempt bonds, it is unlikely to evoke more than an incremental system-wide interest in bank demand. Any immediate impact weakens further in the face of today's already heavily oversubscribed and undersupplied municipal bond market.

Looking ahead, **MMA** expects companion legislation will be introduced (and ultimately approved) in the Senate. However, because even a single Senator can hold a bill from reaching a full vote, and, noting: 1) generally bipartisan antipathy for the tax-exemption; and 2) election-year politics, the industry and its issuers face a more daunting challenge here.

IMPACTFUL BOND DEALS AND ASSOCIATED TRADING

***Below** are __four__ new primary deals that have impacted the market recently with associated secondary trading dynamics:*

Chicago Board of Education, IL

2/3: **JPMorgan Securities LLC** priced $725M unlimited tax general obligation bonds for the **Chicago Board of Education, IL**; NR/B+/B+, Kroll: BBB; callable at par in 12/1/2025:

Pricing Notes: The deal upsized by $50M but no yield adjustments were made during re-pricing. The issuer paid a heavy premium.

Maturity	Coupon	Yield	+/- AAA 5%
2026	7.00	7.75	+597
2044	7.00	8.50	+576

Secondary Trading: On Thursday the 7s of 2044 broke 10 bps firmer than originals and by Monday the bonds improved an additional 5 bps. Trading has been light on the 10-yr bond with a 7% coupon.

Florida Board of Education

2/3: The **Florida Board of Education** sold $118M public education capital outlay refunding bonds to **Wells Fargo Securities**; Aa1/AAA/AAA; callable at par in 6/1/2025:

Pricing Notes: We understand the deal met strong demand and spreads were relatively tight compared to an offering in Oct. '15.

Maturity	Coupon	Yield	+/- AAA 5%
2017	5.00	0.45	+10
2026	3.00	1.76	-2
2028	5.00	1.94	-3

Secondary Trading: No block trades that show movement as of publication.

Dallas Area Rapid Transit, TX

2/4: **Morgan Stanley & Co.** priced $482M senior lien sales tax revenue refunding bonds for the **Dallas Area Rapid Transit, TX**; Aa2/AA+/NR; callable at par in 12/1/2025:

Pricing Notes: Levels were bumped 1 to 8 bps during re-pricing with larger adjustments on bonds with shorter maturities.

Maturity	Coupon	Yield	+/- AAA 5%
2026	5.00	1.92	+16
2041	5.00	2.94	+24
2048	5.00	3.06	NA

Secondary Trading: On Monday, the 10-year bond with a 5% coupon broke into the secondary 4 bps stronger than originals.

County of Hawaii

2/3: **Bank of America Merrill Lynch** priced $236M general obligation bonds for the **County of Hawaii**; Aa2/AA-/NR; callable at par in 3/1/2026:

Pricing Notes: Yields fell modestly following the retail order period, but larger bumps were made during re-pricing.

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.16	+11
2026	5.00	1.95	+17
2035	4.00	2.94	+47

Secondary Trading: On Monday, the 10-year bond with a 5% coupon traded 7 bps better than originals.